SESSION 1
INTRODUCTION TO AUDITING

Learning objectives:

- State the objectives and principal activities of statutory audit.
- Discuss the philosophy of audit.
- Discuss the concept of accountability.
- Discuss the concept of agency theory.
- Limitation of statutory audit.

What is assurance:

Assurance of information produced by an organisation’s management, generally means enhancing the degree of confidence of the intended users.

Enhanced confidence is obtained from the outcome of an evaluation of the quality of such subject matter against criteria, by an independent third party practitioner. The outcome of an assurance exercise is an ‘assurance statement’ containing a conclusion on the quality of the subject matter.

The purpose of assurance services:

- To increase confidence in information provided to the users
- To reduce risk

The type of assurance: 2 types

- Reasonable assurance + high level = Positive assurance report
- Limited assurance + moderate level = Negative assurance report

Three parties engagement process:

- The users
- The responsible party
- The practitioners
What is an audit:

The practice of auditing commenced on the day that one individual assumed stewardship over another’s property. In reporting on his stewardship, the accuracy and reliability of that information would have been subjected to some sort of critical review (Anderson (1977) p6)

- The term audit is derived from Latin word meaning “a hearing”. Auditing originated over 2000 years ago when firstly in Egypt and subsequently in Greece, Rome and elsewhere, citizen entrusted with collection and disbursement of public fund were required to present themselves publicly, before a responsible official (i.e. auditor) to give oral account of their handling of those funds.

- The development of joint stock corporation during the industrial revolution in the middle of the 19th century brought about a need for director to report to the shareholders whose capital they managed.

- In the UK a balance sheet became statutory requirement in 1844. auditors have been required to report on the balance sheet in “true” term since 1862.

- Statutory audit in the UK became mandatory for companies in 1900. At this time purpose of an audit was to detect fraud, technical errors and errors of principle.

The definition of an external audit:

"An audit is an independent examination and expression of an opinion on the financial statements of an enterprise”

Objective:

- The primary objective of auditing is to report on true and fairness of the financial statements. The audited financial statements add credibility.

- The secondary objective of auditing is to detect suspected errors and fraud and assist the management in tackling them.

Why there is a need for audit:

- Assurance (high assurance not absolute assurance).

- Statutory requirement

- Group audit

- Compliance with Accounting standard and Companies legislation.
The Philosophy of Auditing

- Financial statements and financial data are verifiable.
- There are no necessary conflict between the auditor and management.
- Financial statements are free from material irregularities and errors.
- The consistent application of GAAP/IFRS, results in a fair presentation of the financial position.
- The auditor needs to be independent when expressing an opinion of the financial statements of the enterprises.
- The auditor should observe the professional conduct and ethical guidelines when undertaking a duty as an auditor.

Agency theory:

- A director is an agent having fiduciary relationship with the principal (shareholders)

- In meeting their responsibilities of stewardship, the directors have fiduciary duties to:
  1. Safeguard the principals assets
  2. Maintained proper accounting records
  3. Implement adequate accounting systems
  4. Implement adequate internal control systems.

The Social Responsibility Model

- The auditor’s responsibility is influenced more by the society’s expectation from the auditors.

- The results in profession’s self-regulation exercise and in society’s demand for areas requiring further audit attentions.

- Accountable to public interest (external stakeholders).

The main users of audited financial statements

- Shareholders
- Government agencies
- Stakeholders
- Regulatory bodies such as FSA
The role of modern auditors

- The main role of an auditor is an independent examination of the financial statements produced by the company, so that the owners of the company can assess how well the management have discharged their stewardship functions.

- The auditor can be seen as a mediator between the company and conflicting parties.

- The other role of the auditor is the detection of fraud and other irregularities within the company to the management or relevant authorities.

Internal auditing:

An independent, objective assurance and consulting activity designed to add value and improve and organisation’s operation. Objective is to assist management and staff in the effective discharge of their duties.

Value for money audit:

An investigation into whether or not the use of resources is economic, efficient and effective. To identify and recommend ways in which the return for resources employed may be maximised.

Audit exemptions:

- Turnover must not exceed £5.6m.
- Company’s gross assets must not exceed £2.8m.
- Number of employees must not exceed 50.

Limitation of external audit:

- Costly.
- Increased statutory regulations.
- High learning curve for new audit
- Conflict with Management
- Lack of co-operation from Management
- Management fraud.
- High risk business.
OBJECTIVE AND GENERAL PRINCIPLES GOVERNING AN AUDIT OF FINANCIAL STATEMENTS ISA 200

Introduction

The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the objective and general principles governing an audit of financial statements.

Objective of an Audit

The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework.

The phrases used to express the auditor’s opinion are “give a true and fair view” or “present fairly, in all material respects,” which are equivalent terms.

Although the auditor’s opinion enhances the credibility of the financial statements, the user cannot assume that the opinion is an assurance as to the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity.

General Principles of an Audit

The auditor should comply with the Code of Ethics for Professional Accountants issued by the International Federation of Accountants. Ethical principles governing the auditor’s professional responsibilities are:

1. Independence
2. Integrity
3. Objectivity
4. Professional competence and due care
5. Confidentiality;
6. Professional behaviour

The auditor should conduct an audit in accordance with ISAs. These contain basic principles and essential procedures together with related guidance in the form of explanatory and other material.
The auditor should plan and perform an audit with an attitude of professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated.

An attitude of professional skepticism means the auditor makes a critical assessment, with a questioning mind, of the validity of audit evidence obtained and is alert to audit evidence that contradicts or brings into question the reliability of documents or management representations.

Scope of an Audit

The term “scope of an audit” refers to the audit procedures deemed necessary in the circumstances to achieve the objective of the audit.

The procedures required to conduct an audit in accordance with ISAs should be determined by the auditor having regard to the requirements of ISAs, relevant professional bodies, legislation, regulations and, where appropriate, the terms of the audit engagement and reporting requirements.

Reasonable Assurance

An audit in accordance with ISAs is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement.

Reasonable assurance is a concept relating to the accumulation of the audit evidence necessary for the auditor to conclude that there are no material misstatements in the financial statements taken as a whole. Reasonable assurance relates to the whole audit process.

Conduct of an Audit of Financial Statements

The auditor should conduct an audit in accordance with International Standards on Auditing.

ISAs contain basic principles and essential procedures together with related guidance in the form of explanatory and other material, including appendices.

The basic principles and essential procedures are to be understood and applied in the context of explanatory and other material that provide guidance for their application. The text of a whole Standard is considered in order to understand and apply the basic principles and essential procedures.

In conducting an audit in accordance with ISAs, the auditor is also aware of and considers International Auditing Practice Statements (IAPSs) applicable to the audit engagement. IAPSs provide interpretive guidance and practical assistance to auditors in implementing ISAs.

An auditor who does not apply the guidance included in a relevant IAPS needs to be prepared to explain how the basic principles and essential procedures in the Standard addressed by the IAPS have been complied with.